Economic Outlook

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The economy appears to be growing at a moderate pace, but with strong cross-currents beneath the surface. On the positive side, residential construction is on an upswing, while auto sales have moved to a high level. Consumer spending has registered respectable increases, though monthly performance has been erratic. On the negative side, however, a troublesome warning flag has been raised concerning the outlook for domestic capital goods producers, while the prospect of further enlargement of the merchandise trade deficit remains a serious threat. Despite these trouble spots, real GNP is expected to rise slightly more than 4% from the fourth quarter of 1984 to the fourth quarter of 1985, with continued growth likely throughout 1985 and 1986.

During much of 1984 rising mortgage rates caused a drop in housing starts, from 1.95 million units at an annual rate during the first quarter to 1.59 million in the fourth quarter. As an indication of the decline in mortgage rates since last fall, the current rate on fixed-rate mortgages is generally slightly above 13% (plus points), compared to about 14.5% last summer. Our expectation --and one widely shared in the financial press--is that most interest rates will rise moderately during the course of this year as moderate overall economic growth is reestablished. As a result, many potential home buyers probably view the current period as an opportune time to take the plunge. Housing starts will likely average slightly above 1.8 million units in the first half of this year and then decline as mortgage rates rise. Housing starts are expected to total 1.70 million units this year versus 1.75 million in 1984.

Auto sales have recovered visibly since the slowdown in sales late last year. Total auto sales in January and February averaged about 11 million units at an annual rate, compared to 10.2 million in the fourth quarter, with all of the improvement in sales of domestically produced cars. The substantial aging of the stock of cars in the U.S. indicates that potential replacement demand will remain strong. Auto sales are expected to total 10.8 million units this year versus 10.4 million last year. The expiration of the voluntary restraint agreement with Japan will probably result in about 250,000-300,000 more cars being shipped from Japan in the next 12 months, with exports being restrained purely because of political considerations.

One of the most disconcerting economic reports during the past few months was January's 13.2% decline in new orders for nondefense capital goods. Ordinarily a decline in this highly volatile series would not be particularly worrisome, as a decline in one month is often reversed in the next. These orders have trended downward since last May, however, and the situation seems to be deteriorating rather than improving. Since the orders reflect domestic bookings, some of the weakness is undoubtedly due to the strength of the dollar and the inroads of foreign producers in the U.S. market. In addition, some "high-tech" industries, which provided substantial thrust in the early stages of the recovery, are now experiencing rough times. The semiconductor industry in particular has gone from virtual boom to bust, as bookings are now substantially below billings, completely reversing the situation of a year ago. In sum, overall economic growth is likely to proceed at a moderate pace, but the aggregate figures will reflect sectors on the rebound as well as industries in turmoil.

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Economic Forecast

Percent Changes at Annual Rates

	Actual	1985							Forecast	Actual	Forecast	
	1984 IV	I	II	III	IV	I	II	III	1986 IV	1983-1984	1984-1985	1985-1986
Gross National Product	7.8	7.1	9.5	9.0	9.0	8.7	7.9	8.2	10.0	10.9	8.1	8.7
Real GNP	4.9	3.1	5.0	4.3	4.1	3.5	2.5	2.5	4.0	6.9	4.0	3.5
GNP Price Deflator	2.8	3.9	4.3	4.5	4.7	5.0	5.2	5.6	5.7	3.8	3.8	5.0

	Actual	Forecast	Actual	Forecast	
	1984: IV	1985: I	1983-1984	1984-1985	1985-1986
Consumer Spending	6.2%	8.4%	8.6%	8.1%	8.5%
Durable Goods	10.5	12.1	13.8	9.8	8.1
Nondurable Goods	2.1	4.9	6.9	5.6	7.8
Services	8.1	9.9	8.6	9.5	9.2
Business Capital Spending	9.8	12.7	20.5	12.7	9.0
Structures	19.3	15.0	16.0	14.8	10.6
Equipment	4.9	11.3	23.1	11.6	8.1
Residential Investment	-5.7	17.5	16.3	7.6	0.7
			1984	1985	1986
Change in Inventories	$35.3b.	$28.0b.	$57.9b.	$43.3b.	$58.0b.
Net Exports of Goods and Services	$-49.2b.	$-63.0b.	$-62.5b.	$-88.0b.	$-96.3b.
			1983-1984	1984-1985	1985-1986
Government Purchases	11.3%	9.4%	9.1%	10.7%	9.3%
Federal	20.3	11.1	9.6	14.3	10.5
Defense	21.4	12.6	10.4	12.5	12.4
Other	17.2	6.8	7.0	19.8	5.4
State & Local	5.7	8.3	8.7	8.4	8.5
Corporate Profits Before Tax	4.6*	-1.9*	16.9	6.1	6.9
Corporate Profits After Tax	4.5*	-0.8*	15.8	7.0	6.9
Plant and Equipment Expenditures	11.0F	22.1	14.3	8.4	7.1
Real Final Sales#	8.5	3.8	5.0	4.4	3.3
Real Disposable Personal Income	3.9	2.5	6.7	4.0	3.5

Economic Indicators	Recent Data			Actual	Forecast	
	Dec.	Jan.	Feb.	1983-1984	1984-1985	1985-1986
Consumer Price Index**	3.6%	2.4%	n.a.	4.0%	4.3%	5.2%
Producer Price Index for Finished Goods**	2.4	0.0	-1.2	1.8	3.4	5.0
Industrial Production	1.2	3.6	-6.0	10.6	4.3	3.5
Retail Sales##	-0.3	0.5	1.4	10.2	8.2	7.9
				1984	1985	1986
Auto Sales (millions of units, a.r.)	11.0	11.1	11.0	10.4	10.8	10.0
Housing Starts (millions of units, a.r.)	1.60	1.83	n.a.	1.75	1.70	1.54
Unemployment Rate	7.2%	7.4%	7.3%	7.5%	6.9%	6.4%
Merchandise Trade Deficit (a.r.)	$96.4b.	$123.4b.	n.a.	$123.3b.	$148.0b.	$160.0b.

Unless noted otherwise, all data are period-to-period percent changes at annual rates, derived from seasonally adjusted data.

#GNP less change in inventories, both in real terms.
##Monthly percent changes are not annualized.
*Year-over-year percent changes.
**Annual percent changes are December to December (not seasonally adjusted).

$b. = billions a.r. = annual rate F = Forecast

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